

POLICE & FIRE PENSION INVESTMENT BOARD

JULY 25, 2005

Members present: Don Taute, Don Herz, Greg Sorensen, Mark Meyerson, Randall Case, Brad Thavenet, Mark Westphalen, Gerry Finnegan,

Member absent: Michael Donnelly

Personnel Dept.
Resource Staff: Paul Lutomski, John Cripe

Consultants: Max Callan, Todd Peterson

Mark Meyerson: This meeting is called to order. (10 a.m.) Paul, please read the minutes of the last meeting.

Paul Lutomski: The last meeting was May 23rd, 2005. Mark Meyerson was not available to attend that meeting, due to a family emergency, so Vice-Chair Don Taute called the meeting to order at 2:30. I read the minutes of the October 29th and January 27th, 2004, meetings. Randall Case made a motion to adopt the October 29th, 2004 minutes as read. Mike Donnelly seconded. All the members approved. Randall Case made a motion to adopt the January 27th, 2005 minutes as read. Don Herz seconded the motion, and all the members approved. Don Taute asked for a motion regarding the second agenda item, which was the draft investment policy. There was discussion regarding that. Basically it was approved. There were minor changes, and discussion on two items. The first item involved using the Lincoln Municipal Code language pertaining to the Board and inserting that into the investment policy. Second item involved the draft of the asset allocation table. The Board decided to wait until this meeting to decide on the new asset allocation classes and corresponding mins, maxes and targets for each class. Brad Thavenet made a motion to approve the draft investment policy then, with the exception of the allocation table, and to leave the current allocation table. Mark Westphalen seconded the motion and it passed unanimously. Gerry Finnegan made a motion to add a sentence to Appendix A stating that the target return rate be set by the plan administrator. Greg Sorensen seconded. The motion passed unanimously. Randall Case asked Max Callan to describe the differences between the broker-dealer versus advisor relationship, and then the members, after Max and Todd left the meeting, discussed which relationship they preferred. Michael Donnelly made a motion to change the relationship between the Board and Smith Hayes to an advisory relationship. Greg Sorensen seconded that motion,

and it passed unanimously. Maybe Max or Don Taute could give you an update on the broker, or advisor relationship. That's the minutes for the May 23rd, 2005 meeting.

Mark Meyerson: Okay. Do we have a motion to approve the minutes?

Don Herz: So moved.

Mark Meyerson: Second?

Mark Westphalen: Second.

Mark Meyerson: All those in favor say "aye". (*Chorus of "Aye"s*) Opposed? (*Silence*) Motion passes.

Max Callen: If you'd like, I will give you an update.

Mark Meyerson: Okay.

Max Callen: Our attorney is taking, in my opinion, an exceedingly long time in getting documents that are needed. Don and John just received those this morning. So there will be some revisions that the City will want to make but we're moving in that direction, for us simply to work as what is called an advisor.

Mark Meyerson: Okay.

Max Callen: So if we can get the attorneys fired up, it will get done.

Mark Meyerson: Well, it looks like the only thing on our agenda for today is Max Callen and Todd Peterson from Smith Hayes. They are going to review our investments, so we'll turn it over to you.

Max Callen: Okay. Thanks.

Greg Sorensen: Max, before you get started, is the cost the same for broker versus advisor?

Max Callen: Yes. It will be. It's just a function of how we get paid. An advisor technically sends a bill. And that can be a flat dollar charge of "x" number of dollars, or it can be what they call basis points. Twenty-five basis points, fifty basis points. So if an asset grows, we get paid more. And the advisor has to bill the plan, so an advisor technically is not supposed to get paid from third party sources, i.e. mutual funds. Now whatever comes in from these 12-b1 fees can be used to offset that direct bill, if the City desires to do so. On our side of it, there's different rules, there's different

regulations, there's different oversight boards that oversee advisors. That's an SEC function versus the NASD, which oversee broker-dealers.

Mark Meyerson: The 12-b funds can just be treated as any other type of revenue into the fund, I would assume, then, right?

Max Callen: Yes. Technically what happens is the plan is paying those 12-b1 fees via the expense ratios of the funds. As those moneys come back to us on the broker-dealer side, we turn around and give them back to the plan.

Mark Meyerson: Can go in as additional revenue

Max Callen: Call it additional revenue or call it decreasing expense. One or the other. Some advisors say we'll take the 12-b1 fees and reduce the amount that we bill the plan for."

Greg Sorensen: How much do we make?

Max Callen: Oh. It's been awhile since I've looked at that, but I would think that last year, don't hold me to this, but probably \$50,000. Something like that.

Greg Sorensen: To Smith Hayes?

Max Callen: To Smith Hayes. It was I think 5 basis points on assets. In the money management world, pretty cheap. Most places, where you've got a hundred and fifty million dollar plan, fees start at 1%, 100 basis points, and they go down. Some large national firm probably would be 50 basis points. 25 at a very minimum.

Mark Meyerson: Max, there's another difference here. Smith Hayes fee will show up as a line item expense on our administrative cost sheet, where before it wasn't. Correct?

Max Callen: Yes.

John Cripe: And we had an agreement to be rebated some of the 12-b1 fees. We put that in our training and education fund to train you all. This new agreement will change all that, and we'll have to figure out how we're going to fund education. The net cost to the plan will be about the same, if we understand the process correctly.

Max Callen: Okay. Well, about two years ago, we started this process of asset allocation, and talking to the committee et cetera, and what I want to do today is go through a format similar to one we used a couple years ago and that was a big picture discussion, economy, markets in general, then discuss the previous assumptions set up two years ago. Do those still hold

true? Do they not? Look at the present portfolio and some recommendations and changes.

(PowerPoint presentation begins) Three primary countries outside the U.S.: China, India, Brazil. Oil has been a big hot topic. And the debt level in our economy, our society, be it government, or personal debt. Some huge issues there down the road. And then generally the demographics of our population, this baby boom process is certainly affecting us. On the countries, China and the other nations are growing much faster than we're growing, and they're posed to take over a lot of functions that our society did. If you look here at economic growth comparisons, you have Brazil. This may be kind of small to read in the back there, but their economy GNP last year grew about 5.1%. India, growing about 6.2. China, growing 9.1% was 1.3 billion population. Here we are at 4%. So they're growing substantially faster than we are. Now, in the past year, they've increased the number of companies that China is trying to buy or has bought, plus they're also buying a lot of our treasury securities, and while that's good news on one side, it's bad news on another side. They're going to control us. If they want higher interest rates, they can have higher interest rates, just by dumping our securities. These are some companies that are starting to bid, Maytag - I know Maytag is also in negotiations, and I think it is with Whirlpool, so that may or may not happen. But Medieval(?) Group did buy IBM's old IBM PC compatible division, that's now owned by a Chinese company. There's a lot of oil and gas properties that China is trying to buy simply because demand for oil is pretty substantial in their economy. Their bid for Unocal, while I don't think that's going to go through, they're still out there, they're still trying to buy those assets. Japan and China own an awful lot of U.S. government securities. Here's 2001 to 2002, you see it (Treasury purchases) really start climbing. This is the Chinese acquisition of our debt, and it's not peaking, it's still climbing. Japan's climb is kind of leveling off, and China is taking over that increase. Here are foreign holders of U.S. treasuries, Mexico, Canada, there's Hong Kong, there's mainland China, there's Japan, a big big holder of U.S. securities. When we move into the oil segment of things, this is crude oil prices. Right there is April of '02. We've been going up since then. 60 bucks a barrel. That's going to impact our economy substantially, we think. We haven't seen it yet, we haven't seen it necessarily in prices, you see it in the pump a little bit. We were talking earlier, I was talking to Mark, you know back in the '70's when we had oil shortages, and big oil lines, people paid cash. Well, now it's credit cards, and so you don't hear the outcry as much because they're just charging it, and I talked to a friend of mine who works at First Data the other day, I just said, "Hey, how many of your card holders make only the minimum payment?" and he says, "About 49 or 50% of people just make the minimum." This is kind of interesting. This is the futures market. And this was in October of '04,

this blue line. And the futures market kind of lets you know what people anticipate paying in the future for prices. And you see here they thought, looking out 36 months, that they'd be at \$40 a barrel oil roughly, and now in March of this year that yield curve is clear up here where they think they'll be paying \$50 per barrel, so the chart is basically saying those that who deal in oil don't think it's coming down. It's going to stay at a high price and that impacts plastics, and a lot of different things that we use in our economy. Another thing, on the debt side, there's three primary areas of debt, there's the housing market, there's consumer consumption, video games, you know, and t.v.s et cetera and there's a government side of debt. On the housing front, prices rose 12.5% from a year ago. Median price for a home is \$217,000 in our country right now. They're escalating a lot. Sales of 1.3 million units. Predicting over 2 million units. That's a lot of houses being sold. And then one thing I see and this bothers me, people retiring and their discussion of going and buying a new house. I sat down with a gentleman from a manufacturing company here in Lincoln this past week. He's got \$200,000 in his retirement account and he's 65 years old and he wants to go buy a new house with that money, and my first question to him is "where are you going to get food?" Oh, he hadn't thought about that. Well, you've got a lot of lenders out there. They're pushing credit, okay? And credit is very easy to get, and enticing people to go do some things that maybe long term aren't very . . . Do you want to rent or do you want to own? You've got a very young person. Well, we have apartments and we have houses. This is a pretty nice house here in Lincoln. Okay. Well, a lot of people are getting into some very nice houses that really maybe they can't afford to be in. Well, they start with low rates, lax credit standards, very little down payments, forty-year interest only loans. Some of the advertisements you see are just really crazy this way. Well, that all stops when the creditors start getting burned or a regulatory body comes in and says, "You can't do that anymore." That will slow down that credit market. Here's U.S. sales, home sales to inventory. Here's our inventory number. Relatively flat, climbing a little bit. Our sales, still climbing. Okay? Again, that's just fueled by mortgage lenders saying, "You can do this, we'll loan you the money to do it." So this last economic recovery, if you would, that we've had has been all debt driven. It's not because we're going out buying new manufacturing plants and building new products, but somebody loaning somebody else money and then they just go spend it. Consumer outstanding credit, one trillion dollars in 1994, over two trillion now. Until somebody turns off that tap, that is going to continue to increase. This is also a very interesting chart. It's inverse in relation to home prices. So here are home prices over on this axis, and here is the savings rate on this axis. We used to have a seven to eight percent savings rate, when we had about \$100,000 average price home. Now home prices have gone up and we've used that leverage and our savings rate is almost at zero in this country. Our citizens are not saving anything. Again, long term, that's

not healthy. So we look globally at who savers are and who spenders are. Japan, big savers. Germany, Russia, Saudi, China, good savers. Okay? We flip to the spender side, net borrowers, U.S. by far the biggest borrowers in the world. We're not afraid to sign our name on the line for anything. Long term this will hurt us as a global economy. National debt levels and some of this debt is for military, but some of it's also federal home loan board, you know, Fanny Mae, Ginny Mae, those sorts of things that create mortgages. This one is adjusted for inflation to the 2000 dollar. We have had a great increase in the '90's in our debt dollars. Unemployment rate basically full employment. High unemployment in the early '80's, which could be coming down ever since then. Average unemployment since 1970 is 6.2%. Since '55 is 5.8, and we are below those levels. So it's virtually pretty much full employment. So the overall market performance. This is through June 30. Right here year to date numbers through June 30. Pretty much everything has been down. We've had a nice rally pretty much through the end of June. Things have popped up to where we're pretty much flat on a couple of the indices. The Dow, -. We'll just go through all these indices. The Dow is only 30 stocks. Very narrow. But that's what you hear on the news, because it's the one that has been around the longest. The NASDAQ, it's called technology market. That's not necessarily true. There's a lot of companies on the NASDAQ that are not technology oriented. But some of the more volatile, a lot of small cap areas, stocks are there. Got your S&P500, the largest 500 companies in the U.S. Russell 2000, typically small cap are the focus. And then EAFE represents foreign markets. Europe, Australia and Far East is what that stands for. If you look here, 5 years, and that will take into consideration the bear markets of 2000, 2001, 2002. Negative for a couple of years. On this chart colors are probably the more important thing. Different styles, and we try to bring that into your asset allocation model. We have some small cap value, we have some small cap growth, mid-cap, et cetera. Here is when large company and growth have done well. Somewhat focuses large value, large growth, large value, large growth. Generally speaking from about right here back large growth is pretty much in the upper half of the chart performing very well. From here, 2000 and forward, it's down at the bottom, not performing as well. But things do kind of go in cycles. The mid-value doing very well here. We think that in the allocation we'll recommend later, it's probably time to add some more into these areas, into the growth side. We had the model shifted more towards the value side before. We're going to go back to more of a neutral position. On the foreign side, these are the world markets. The green is emerging market countries. China, Indonesia, those areas are getting very, very good, where they used to be down at the bottom. Our S&P, as it relates to the world markets, even though it's still positive here, has been a lagger in terms of performance compared to other world indices. This chart goes back to about 1926 and adjusted for inflation. It's kind of interesting. The markets had a pattern, somewhat of

a pattern. This is about 17 years in here of generally flat markets. Then they go up. Then they go flat. Then they go up. Okay. We put that on cycle from 1930 to 1946, and you say that's only 16 years, no, that's 17 years, because 1930 is one. That S&P 500 total return over that time period annual return is 3.5%. The next 17 years, it was 15%. Substantially more. The next 17 years was 7.6%. Okay, which would have met your bogie, in terms of your retirement plan. But still substantially lower than the previous one. May '81 to '97 we have another great 17 year period. We don't know what this next one will be. But for us to do asset allocation, we're asked to make decisions as to where markets are going, what they're going to be like. We think they're going to be more like this (flat), than this (up). U.S. markets predominantly. And in our previous model we said they'd be like the '60's and '70's, the equity markets, and that's like this time bracket here. Now we look at interest rates. These are time periods where the Fed funds raised. 24 months and 2.75%. Here in the mid-90's there was a 13-month and they raised it 3%. Here was 13, yes, 13 months, 3%. There's 11 months, 1.75%. We're right now into a 12-month process of fed raising rates, and they've raised it about 2.25%. We think that will probably continue a little bit. We don't know how much longer. The feds really are in a quandary. They can't raise it too far, too fast. They don't want to bring on a recession. This is the yield curve from when we started a couple of years ago this process, June of '03 to June of '05. The green line is where it used to be, and the white line is where we are today, and we have very much a flattening of the yield curve. By flattening we mean the short end has come up and the long end has come down. And that's what's baffled Fed Chairman Greenspan a little bit. He would have thought that this end would have continued to go up some.

Gerry Finnegan: To what degree can you attribute the lowering on the long end to a belief that inflation is not going to get out of control because interest rates on the short end of it raised? By raising short term interest rates, we've fought off inflation, and the long end is responding to that.

Max Callen: Yes, I think that's true. And I think also some of it is they've (U.S. Government) been able to sell their debt. Part of the interest rate model is that the government has debt to sell, and obviously they want to get the lowest rates they can, and China has been there willing to buy that debt. You know the housing market here with the low credit standards, that's caused the rates to stay low longer than normal. I don't know how you can have the \$60 oil when it's such a big part of the economy and not have some inflationary pressures long term. One thing that baffles me about government statistics we don't have inflation if we exclude this item and this item and this item. Sometimes I think that the target moves all the time. But this phenomenon (17 year cycle) is kind of interesting. And I think the fact that we do have players that are dead on government debt

has allowed this to stay maybe more flat than it would have a few years ago.

Max Callen:

This was an interesting quote from an interview of Warren Buffet in Fortune Magazine of 1999. He said, "Pension fund managers continue to make investment decisions with their eyes firmly fixed in the rear view mirror. This general fighting the last war approach proved costly in the past and will likely be equally costly this time around." And basically what he was saying, and that was right at the peak of technology and when everybody was saying things will continue just to grow forever, he said, "You can't do that. Investors should not make allocation decisions based on historical investment performance, but on fundamental evaluation." So Buffet, I mean he's the guy that looks long term and looks at something and tries to buy undervalued, doesn't understand technology from evaluation perspective how you could pay what you pay sometimes for some of the technology stuff. So I want to go back and look at some different time periods. This was private pension funds percent of cash flow put into equities. In 1971, pension managers had about 91% of their allocation to equities, and 10 years later stock returns were 8.45%. If they left their money in equities through that next ten year time, during the 1980's they would have had an 8.45%. But in 1973, they only had 13% in equities, and the return for that next 10 years was 10.6%. The point being is between '71 and '73 equities went down in value substantially. They were much more favorably valued in 1973 than they were in 1971, so you've got to try and look at fundamental evaluations where the market is selling as in relation to historical norms. If it was high like it was in '99, I would say you don't have as much in that piece. What causes those swings is greed. The only two things that make markets go is greed and fear. When things are the worst, that's when you probably ought to be buying. When everything looks like it's going the boom, that's probably when you ought to be selling. So in a very simplistic model, we as pension managers here, we've got - we're going to put things in two places: stocks or bonds. Went back to look at 1962 coming forward, there are 33 ten year periods. Of those, there's only 5 times that equities did not beat bonds. In 5 ten year periods in performance, they didn't beat bonds. The average performance of stocks was 4% over equities in those 10 year time frames. But there were 16 periods when bonds were over 7.5%, so if your pension has a 7.5% hurdle rate that we're trying to hit and the objective is to do that with the least amount of risk, we would have had 16, half the periods, from '62 to current time, if we could have gotten our returns by being 100% in bonds. So the question always becomes, "What are the markets like now?" You know, we're not at seven and a half percent bond rates. Because our bond returns, we know what they're going to be (if held to maturity). We buy bonds right now, 10 years we can get about 4.5% 10-year bond rate. Well, equities is from the unknown. We don't know if we're going to get 20% returns or if they're

going to go backwards. But during those time periods when we know we can't get it on the bond side, we have to put a little more into the equity side. So during periods when they meet your returns, increased bond allocations, and, when they don't, increase your equity. As an example of that process, in 1967 10-year bond returns were 5%, so we couldn't have gotten the return we needed by being in bonds. So if we use the rear view mirror approach and we look back and we said, "Okay, from 1957 to '66, equity returns 9.1 million percent, we think they'll do that for the next 10 years as well," so you calculate and it says that we put 58% in equities and put 42% in bonds. The combination of those two things will give us our 7.5% return. But what would have happened if over the next 10 years you had a 42% in bonds and the return there was our coupon rate of 5.1%, but the stocks never returned 9%? So the point being is when we look backwards, past performance does not equal future success. You hear that over and over and over again, and sometimes when you model based upon what's happened in the past, you can really be off target. You've got to say, "This is what we think things are going to be like in the future." Allocations are going to be right sometimes, and are going to be wrong sometimes. But you try and do it so you don't make large errors. The typical mindset today is "Well, what happened last quarter? What happened last year? What happened maybe the last three years, at most?" Well, pension time horizons are really long term, 25, 35 years, and so when we take 10 year time frames, to us in this room that may seem like a very long time, but in the pension world it's actually a pretty short time. So, let me go over now the previous assumptions. Where we were, how we got to them, etc. In 2003 we said the equity markets would be similar to the '60's and '70's, so by that we said a fairly flat market. We said that value was going to outperform growth. We said that small caps were going to outperform large caps, in general. That bond returns would be historically low and similar to the '50's. So given those assumptions we had our 7.5% return. Here's what the markets were like in the '60's and '70's. Large growth did 8 in the '60's, in the '70's it did 3.6. Large value did 11 and 12. Small growth, etc. You see here, small outperformed large in general, and value outperformed growth in general. So that's what we were basing our assumptions on. And on the bond side of it, here's some coupon rates for bonds. 1934 they were 3.25%. Then they were 2. In '54 they were 2.37. They didn't get up to 4% until '68. We were, two years ago, we were about 3.62 was what our 10 year bond rate was. And we don't know what the 10 year return is going to be. But you see here, pretty well parallel the coupon rates. It's not until you hit the '70's and the '80's that you get some higher rates of return on those yields. Here's a large cap growth comparison shifted just a little bit. This is the '70's market in blue, then you overlay 2001 versus '73, our equity markets, large growth, and while the returns are not exactly the same, the patterns are similar. It says here, we don't know what '05 is going to be like, we don't know what '06 is going to be like. But we may not have stellar

growth, this year as we go forward. You look at the international markets, fairly similar, these patterns to the international markets in the '70's. But they had higher growth rates here, than domestic markets. So these were the parameters that were originally set out. The min.'s and max.'s in cash, in '03, 1% and 3%. Bonds, 20 to 50%. Foreign, 5 to 15. Tips, 2 to 10, and TIPS stands for "Treasury Inflation Protected Securities." So they're government bonds basically, they're tied to the inflation rate, and as inflation goes up, your bond yield goes up with it. And then on the stock side, we have total allocations 20 to 50% maximum in stocks, and we broke it down, large, mid, small, and really within these categories we split it between growth and value, so it was 3% in large growth, out of 20% maximum in large growth, and 3% in large value [out of] 20% large value. Then hedge funds, 3 to 10, and real estate 2 to 15. But we look at what's happened since then in return perspective. Here was our return assumptions that we used. The bonds we did about 4%. But your portfolio from '03 to '05, annualized time-weighted rates of return, and this is taken from software that Paul uses, your bond portfolio did 5.2% and the index, which in this case is the Lehman Brothers Index was 3.8%. Our foreign bonds did about 6.5% compared to the assumption of 5. Our real estate did 11, frankly a lot better than we had anticipated that it would do. And then cash is about 2% in. Come over to the equity side. We have assumptions, foreign was about 8 and it did 22. Okay, the index was 22. Large growth did 15, substantially better than we had anticipated it would, and the index did 9. Here are the indexes. They're kind of similar to our original strategy, that value would outperform growth, and if you look at just every category, mid-value outperformed mid-growth, small value outperformed small growth. And, you know the fact that the markets were so much better than we thought they would be, it was a good thing, obviously. But we're not here to predict what we know what rates were going to be in the future, so in relationship that's now occasion of putting money into the right buckets, if it makes sense. In some areas we clearly outperformed the indexes, in some areas we're slightly below indexes, and that might have been one manager performed better than the indexes, and one manager didn't. This mid-cap growth then, that's where we had that Smith Hayes Cap 20, and it's really not a mid-cap growth, but that's where it was at the time we bought it. They could switch around, if you have some suggestions at the end, we'll switch them. Where that gets moved to will change. And all the indexes that we use down here were the indexes that we're proposing on the new allocation model. So what do we see now, looking forward? Obviously these are forward-looking, lots of room for errors, that's a disclosure. You know, not guaranteed, they're hypothetical. We think inflation is going to increase, but it's going to be under control. The Fed doesn't want to cause a recession by forcing rates too high, too fast. That's a tricky process. We think job creation is going to come from smaller to mid-size companies. It's not going to come from the larger companies. A lot of your large companies are currently battling

... you know, GM. The benefits they have to pay are just huge, and so they're battling those issues. New era of entrepreneurialism in the U.S. We have to become creative to keep up with the world markets. We think large companies will get growth opportunities for sales outside the U.S. Then we've got some serious demographic and debt issues in the country, real serious. So our return hypotheses is that rates will remain low. We think mid and small will outperform large, as a general statement. We think value and growth will be more similar in performance, over the next two or three years. We think international equities will outperform their U.S. counterpart. So in the model that we'll hand out here in a second and that you can see on the screen, we modified our assumptions slightly. We raised bonds up to the current coupon ten-year coupon of 4.5%. Foreign bonds we left the same. Real estate we decrease the rate, because we think we won't have real estate appreciation, and some of the real estate funds have cut back, i.e., CNL, being one of them, cut back the distribution rate. So we think that just the overall full return from real estate investments will be declining. Over on the equity side is where we've made more adjustments. Foreign we've moved up. Showing the up performance that we think foreign will get. Large growth we moved up to equal the large value counterpart. Mid-growth, mid-value, are going to be similar. Here, your mid, small, slightly outperformed the large. Hedge funds will be about the same, so they decreased slightly. Then we're suggesting that you consider adding some new categories. One would be one global. Okay. Global is simply anywhere around the world, and typically the global funds that are out there would be large cap in nature. Then on the foreign side, there continue to be more and more and more categories. It used to be just foreign was considered foreign, but now you can find large, mid small both value and growth. Certainly emerging markets have been around for a while. While we may not put anything into these allocation classes tomorrow, they're certainly going to become more and more predominant in your portfolio two years from now and three years from now, etc.

Gerry Finnegan: Global isn't an asset class. It's a mutual fund categorization. It's simply a combination of domestic and foreign.

Max Callen: Correct.

Gerry Finnegan: How is that new in any way with respect to our allocation?

Max Callen: Well, it's only new from the **[END OF TAPE 1 SIDE A] [BEGINNING OF TAPE 1 SIDE B]** (respect that a global allocation manager will be allowed to move assets between domestic and international assets within the global allocation.) There's some really good, we think, global funds that can shift into the portfolio. We meet a couple times a year. We're not shifting that allocation all the time. For certain global managers, if there's

a time when they think that foreign ought to be a little better, then they do that shifting for us and then we simply report and monitor that.

Gerry Finnegan: You say there's something that is preventing you from using a global fund right now?

Max Callen: It's not in the asset allocation model that's been approved.

Brad Thavenet: Well, it's not in our model for our group.

Max Callen: It's not in your investment policy.

Gerry Finnegan: Sure it is.

Max Callen: No.

Gerry Finnegan: We don't have to categorize every category of mutual fund. We're just talking about asset classes in ours. Global is not an asset class. It's a combination of two asset classes, so if you invest in a global fund, we then know that it's going to need a custom-index that's a combination of our domestic and foreign. But you're not precluding them in anyway based on our policy from going global.

Max Callen: We've taken the assumption that we were. If that's not the case, then we were in error. We will just add it. I mean when we see a management we think will fit there, we will put it in.

Gerry Finnegan: There is no existing fund out there that you would be precluded from, because we could come up with a custom index for any technique that you're using.

Don Taute: Well, what you're saying is that right now we have an asset class of foreign equities.

Max Callen: Right, and U.S. equities.

Don Taute: We have U.S. equities. Not a combination of both into one.

Max Callen: Right. We've never used a manager that splits those two on some basis. We've said, "Manager A, you're an international manager," and "Manager B, you're a U.S. manager," and so we've looked at it as two separate categories, rather than getting that guy to spend it between. All right? A little quiz. How many of these are U.S. and how many are foreign? Any idea? What?

Don Herz: Zero.

Max Callen: Zero. Pretty close. Only one that's U.S. The point being is to have more and more foreign, whether it comes to be in the global route or whether it comes to be in foreign allocations. Now this is which markets performed better. Here is a ten year time period. Global outperformed the U.S. seven out of ten. Seven out of ten, U.S. outperformed global. Maybe into our time frame here we're 7 out of 10, global outperforms U.S. again.

Gerry Finnegan: But again -.

Max Callen: Global is not an asset class.

Gerry Finnegan: Yes. It's the foreign component that is (????????).

Paul Lutomski: What was holding us up in the past, Gerry, was if we have an allocation of 20% international and 30% domestic and are full up, we have a global manager and other managers that are specifically domestic and specifically international, when the global manager switches to more foreign, are we then obligated to sell some foreign manager, or if they switch back to domestic, do we need to sell some domestic piece to get back in our targets?

Gerry Finnegan: Understand, but that's going to happen whenever your manager trying to time what asset class he's in.

John Cripe: It doesn't happen if we just buy global and everybody says we want 4% in global.

Gerry Finnegan: Well, because you don't know what you have 4% global. Since global isn't an asset class, and your diversification criteria is done by asset class.

Paul Lutomski: We can rebalance and sell some of this and buy some of that by finding out from the global manager what percent of their money is domestic, what percent is international. If that's what the committee wants we can do that. If the committee would rather just say, "let's call something global and skip those adjustments," that's up to you guys.

Gerry Finnegan: Asset class is going to be the determinant. And that's what we did with this new policy, is we tried to get away from the various groupings with mutual funds and define things by asset class, because ultimately that's going to determine where we end up at the end of the line.

Max Callen: Again, we talked about what global managers do. This is in effect what they do. Let's say this is a large company fund. June of 2005, they might have 60% foreign equities, 30% U.S. equities, a little bit of cash, and in February of next year they may be 40% foreign and 60% U.S. They do

that swinging. You don't know when they're going to swing. Yes, periodically you can go and get those allocations, but if you have an investment policy that says, "we're 50% large cap in focus," but you may find yourself 30% at some point in time, or you may find yourself 70% at some time. So, here are some recommendations that we would have. The current maximum that you can have in the foreign equities is 15%. Again, we think that should go to 30%. All equity allocation going from the 65% maximum to an 80% maximum. Currently we have 50% domestic, maximum of 15 foreign, and that's how you get your 65, so by increasing that we're not taking away from something else. And then reclassification, the Smith Hayes Cap 25 is designed to beat the S&P 500. They don't just buy large cap funds. We think that should go into the alternative category, and maybe reduce the allocation to the Cap25 by about half. It has outperformed the S&P, so its beat that benchmark and it's trying. Add a new mid-cap growth manager in its place. That's truly mid-cap growth. Either one or several managers. Let me hand those out. In the packets you'll have these, but it's a little hard to read up here (on the PowerPoint Presentation), the modeling we've done. There are two models. The first is current allocation without the increased foreign parameters. These are all the indexes that represent the funds that we're trying to mirror. If you use the assumed rates of return parameters, this little dot on this efficient frontier is what creates this return, 8.4%. Then on the second page of the material you have with this graph, it shows you how much would be allocated to each asset class. The Russell 2000, which is your small company value, we have 17% of the portfolio. Bonds in there 20% of the portfolio. Foreign would be the 15%. You can see the probability of hitting your target return is circled on this one. It's not circled on your form. That's a 54% probability. So what I'm saying is based upon those return assumptions looking forward, you have a fifty-fifty shot of hitting 7.5% over our time frame. Now the second set of reports you have is with the increased foreign parameters, and there you see we're up to about an 8.91% return. About the same standard deviation. There is now a 60% of probability of hitting the target return. Again, these models are all driven off assumptions you put in, in terms of where you think rates are going to be. We did not use historical rates of return, the last five years, the last ten years, because frankly we think those are probably too high. So we used those assumptions, '60's and '70's, staying consistent with that typical mindset. Okay? You currently have about .79% in cash. Domestic debt, we put the tips into this domestic debt area, that's how it's 22%, and the 60% on the bond side. You're currently at 25. Your target would be 20. Foreign debt, a little below. We need to raise that a little bit. Real estate, you would move out of some real estate, based upon the new model. Alternatives are actually increased a little bit, based upon the changes we suggested. Here on the equity side, we divided our maximum, so we actually increased our equities a little bit, domestic equities. Here you see the changes that would happen as we

move down. We increase our mid-value, quite a bit from where it is today. Leave our mid-growth about where it is. Our large value will go down. Most of that goes to the international side. See the international goes from 5% to the 15% model here, unless you say you would increase that to 30%, we put the global fund in. If you don't want the global, then this would go down right here to the international side. So I'll open discussion about models, about strategies, and about whatever. Gerry?

Gerry Finnegan: On the front page of the "Proposed" one with increased foreign you have a projected portfolio return of 8.91%. Is this for a five-year time horizon?

Max Callen: Ten years and a standard deviation of a 10.91.

Gerry Finnegan: My question is since we only need a 7.5% return, by moving to the lower left on the efficient frontier, couldn't we increase our probability of making our target substantially? Take less risk.

Max Callen: I think it works the reverse of that. Because your fixed rate is below your 7.5%, so the only way you can get there is by having more assets in the higher risk, higher assumed rate of return classes.

Gerry Finnegan: Irrespective of the combination that you're using, if you move to the lower left, you're reducing your risk and your return, but by reducing your risk, you're increasing the likelihood that you're going to meet or exceed the 7.5%.

John Cripe: Last time when we had this discussion, two years ago, when we built the original model, this group as a whole, some of you weren't members then, but the discussion was that we understood you're having to make the 7.5%. We thought it was too, too, precise for everybody to say, "Let's just make the allocation based 7.5," because 7.5 is a real number, that is our charge. As an example, when we're talking about how much the actuary is going to assess against our funding, so in order to assume that we were going to really make the 7.5, we all as a group discussed making sure that we did cover it. We covered it with less than a percent, which is 8.4, instead of 7.5, so the group as a whole decided with their vote that a little more risk to take the chance that you would make it versus having to go the other direction, because we really do have to get charged against the 7.5.

Gerry Finnegan: I understand. But we made that change in the policy that we wanted to minimize the probability of underperforming our 7.5. Not provide a cushion above it. We wanted to reduce the probability of underperforming. Yes?

Paul Lutomski: I just want to make sure that myself and everybody is understanding what

these numbers mean. On the front page of the original that says, "Current Portfolio"? "Portfolio return 8.4%." There's a second page, it says "Probability of target return." Now the target return if I remember correctly is not the 8.4% that's on the front page, it's the 7.5%, Gerry, so when it says one year or time horizon, even though it says 8.4% on the front page they're saying there's a 51% chance of getting 7.5% and a 54% chance of getting 7.5% over the time horizon. It's not the 8.4%, and the same thing with the new ones that have a higher foreign exposure, even though it says, "8.91" as a portfolio return, the target return is still 7.5%, and those probability percentages refer to the 7.5%, not the, not the 8.91%.

- Gerry Finnegan: Let me back up then. Because the portfolio return that you show on the front, what that tells to me is that's the 50th percentile, where it's a 50% said chance of beating it, and a 50% chance of falling short.
- Paul Lutomski: No, that's the 7.5%. There's a 50% chance of getting the 7.5. There's probably a lesser chance of getting the 8.4%.
- Max Callen: I mean concurring the probability issue, you'd actually hurt yourself by moving down the curve, because again you're pulling out assumed higher rate of return asset classes for a lower standard deviations.
- Gerry Finnegan: Maybe I'm misunderstanding what you have printed on the front. When you say "Portfolio Return" what does that mean? You have a portfolio return of 8.91% and a standard deviation of 10.91%.
- Max Callen: What that does is it takes all those different assumed rates based upon your max and min parameters that you put in for each asset class, and it brings that together to then come up with a return, assumed rate of return of 8.91%.
- Gerry Finnegan: So, we structured our portfolio, with this return and standard deviation.
- Max Callen: Right.
- Gerry Finnegan: Okay. What that tells, tells me is that that's the 50th percentile. That's our probable return. We're 50% likely to be above it, 50% likely to be below it.
- Max Callen: Right.
- Gerry Finnegan: Okay. At ten years. Now, my question is that's 1.4% above our 7.5% target.
- John Cripe: And that's the model they've got right up here (ad hoc on the screen). Your probability of making 7.5 is 48%. You're more likely not to make it

than you are to make it.

Max Callen?: And over a ten-year time horizon, it's a 44% probability.

Gerry Finnegan: That you'll make seven and a half.

Max Callan: Yes, right.

Gerry Finnegan: If you've got a 44% chance of making a seven and a half percent return, then you can't possibly have a 50% chance of making an 8.91.

Max Callan: There isn't a linear relationship between return and the risk you're getting.

Gerry Finnegan: Understand. But there's no way that you can have a 50% chance of exceeding 8.91 and have a less than a 50% chance of exceeding 7.5, so -.

John Cripe: It's all based on 7.5.

Paul Lutomski: When you move down the efficient frontier from the 8.4 to the 7.5, you're replacing foreign assets with domestic or bonds or something like that -.

Gerry Finnegan: Yes, and it reduces your return and risk.

Paul Lutomski: It reduces your return more than it reduces your risk, because of the non-linear relationship.

Gerry Finnegan: I think by reducing risk you cannot be less than 50%, if you move south and then west.

Paul Lutomski: Well you're reducing both. But you're reducing your return, I guess, more than you're commensurately reducing your risk.

John Cripe: It's all built on the target of 7.5%. It's all built on the seven and a half. That is what we're trying to achieve. So in order to make seven and a half for the ten year period, it takes more risk, more variance, to ensure, by probability, that we'll make seven and a half. We're not trying to make 8.9, we're just saying that is the structure that is likely to produce something greater than seven and a half, with a reasonable amount of risk.

Gerry Finnegan: But let me, let me rephrase my question. If the way we have it structured gives us a 54% chance or whatever it is of making our seven and a half over ten years, what does that 8.91 represent over the ten years?

Max Callen: That's the same thing, but now you've put it, you've taken one thing out of your model, you've gotten something else into your model and that's more international. If you'll look on the second page you'll see that the

foreign is now 30% of the portfolio, where in the other model it's 15% -.

Gerry Finnegan: Okay. Let's get rid of the other model and just look at this sheet.

Max Callen: And that's the current one.

Gerry Finnegan: No. We're going to look at what you're proposing. What is the likelihood over ten years we are going to get 7.5%.

Max Callen: 60%.

Gerry Finnegan: Okay. What does 8.91 mean over the next ten years?

Max Callen: That's the one year time horizon.

Gerry Finnegan: That's a one year time?

Max Callan: Right. Based on -

Gerry Finnegan: Okay. What is our ten year? Our ten year would then be 7.5?

Max Callan: Yes.

Gerry Finegan: What is our ten year standard deviation? That's really what I'm trying to get to.

Max Callan: Oh. I don't know that it gives that there.

Gerry Finnegan: Can we get that number?

Max Callen: I'll see. (It is 3.4%)

Gerry Finnegan: I think that would be a very large, large number. Wouldn't it be very small? Be substantially less than 10.91.

Brad Thavenet: So to return to what you were saying earlier, Jerry, if you move south and west on just this model, our probability of hitting the 7.5 would be better than 60%.

Max Callan: Actually it's less.

Paul Lutomski: Gerry's concern is valid. He wants to make the seven and a half percent by taking the least amount of risk possible, so can you address that question? Are we taking the least amount of risk given the basket of asset allocations that you've discussed to get to our seven and a half percent?

Mark Westphalen: Before you address that question, because I've been thinking about something as Gerry's been discussing that. If you look at the proposed portfolio allocation, down at the second category where it says "Lehman U.S. Aggregate", I'm assuming that that's U.S. Bonds, 20% weighted. To get this more conservative weighting, we go to a 40% weighting, and to me, I just don't understand in what I see day to day with average long yield, you know long term U.S. governments at 4 to 4.5%, how we're going to be able to get a higher return in a rising interest rate market. I think it adds risk to jump from a 20% weighting in U.S. bonds or corporate bonds to 40%. I don't think it lowers risk. I think it increases our risk and I think that's what that number is indicating. Because I don't - You know the - You tell me, Paul, what kind of - I don't know what the average coupon rate is in our portfolio. But the only way to get a 7.5% total return, we've got to see a profit in those bonds, and I don't think we're going to see that in the next 12 to 24 months.

Paul Lutomski: We're being very defensive in our bond purchases.

John Cripe: We have a two year horizon.

Don Herz: I've seen some models where the long term is going to drop to 2%, an inverted curve.

Mark Westphalen: Right. And if we do that, then we're going to lose money.

Don Herz: We'd make money.

Paul Lutomski: We'd probably still make money. We won't make as much money as if we had a 10 or a 30 year duration.

Don Herz: Right. Right. We'd have to have long bonds to get a profit.

Paul Lutomski: Well, you'd make more profit in a long bond than you would in a shorter bond. It depends where you're at on the yield curve, and how that part of the curve moves.

Don Herz: Right.

John Cripe: And whether or not that's just a bond and whether or not it's some kind of other instrument we have at a fixed rate. I mean if you look at all of the fixed related instruments they're still not going to produce 7%.

Mark Westphalen: Oh, no. No.

John Cripe: We can't stay with this fixed allocation and reach our number. I mean it - as it stands today.

Max Callen: And again, we've assumed rates of return that may or may not be valid.

John Cripe: And you know this is kind of a curious discussion we're having because 7 or 8 years ago people were sitting at the table screaming at us that we wouldn't go past 50% or 40% of equities. We're sitting here saying you want to reduce our fixed and everybody's going, "Wait a minute. I don't know if that's going to produce enough income." Well, you know, it has to at this stage. Fixed is not producing what we need. At the time the argument was happening, it was producing exactly what we needed and the true return was correct. It is not going to be sufficient today going forward, but five years from now we may be back in a situation where it is producing what we need with a considerable less risk and then we have this annual discussion where we modify it again. I mean we've gone through tremendous changes over the last three or four years with how we review all of this. And I think this is a further clarification where we need to go. And we'll see what happens with employment, what happens with the baby boomers leaving the economy and you all heard CNL talk a couple years about all the people retiring and cashing out, and what's that going to do with the market and what's that going to do with bonds, we don't know. But clearly we can be facing this 40% is a good allocation when review this 2 or 3 years from now. But it is not a good allocation today, to get our 7.5.

Max Callen: Yes, to the extent that you can find something that gets you 7.5 and it's a comfortable investment, yes, you buy it. You buy all of it that you can, okay.

John Cripe: We've been doing some of that. I mean, we've been finding little bitty places where it gets closer to 7.5, but by and large, it's a 4, four and a half percent market.

Mark Westphalan: The only area that I have seen 7.5% in a fixed income arrangement is the American Funds high yield trust fund, which is a high yield bond fund paying 7.2 as the yield at NAV right now.

John Cripe: We can't even get it turning over mortgages quickly, because everybody's done refinancing. I mean you just can't move this money any other way.

Max Callan: I think Gerry at one of the previous meetings commented about the 7.5 number may be pretty high number, and I concur. It may be difficult going forward to hit that number if our equity markets continue to do what they did in the '70s.

John Cripe: And we had quite a discussion in the late '90s with regard to, I think Jim Domgard was the police representative, encouraged us to move that

number forward. I think we started at 6 and we ended up at 7.5 over a few year period, because we were earning much greater then. We were earning the 9's and the 10's and without much risk. Well, it all kind of balances out in the long run. And when you are trying to look at ten years or fifteen years out, stability is a little bit better factor than shifting and moving all the time. We'd have probably been a little bit better off if that number was 6.5 today instead of 7.5. I mean we'd be underfunded at a greater rate, but we - The assumption would have clicked in over that time period.

Gerry Finnegan: Well, really the only reason we have any fixed income in this portfolio is to stabilize the portfolio volatility over shorter time horizons. We look at our perpetual time horizon and we can put up with volatility. We ought to be 100% in equities and just not worry about it.

John Cripe: Except for the reality that we have to manage cash and we have to manage investments without selling. I mean it's not a model portfolio. It is a live active portfolio, so when these guys retire, and we roll over their DROP of two or three hundred thousand, we need cash or the million dollar payment just to make the checks go to retirees, so there has to be some cash fluctuation in there, and it can't always be to sell a stock and bonds are good for us for that, and so are the ones that have been paying dividends if they pay a little bit better, our cash flow is better. We had looked a long time ago at targeting enough bonds to make the cash payments, so that we would not have to bother the equity side, and it just has never worked out where we could see that income.

Max Callan: We've been involved with the City beginning when they started because they wanted to put 5% into equities, and it was 100% in bonds.

John Cripe: And at the time we were earning 8 or 9% on bonds. We clearly aren't making any of that today, and certainly it's more realistic to move in this direction for the next year's review and then here we are back to the table saying, "Yes, maybe Greenspan was right. We went to the full overnight and we're back to yields of 5 or 6 and the allocation, it's better." But today it doesn't look better.

Mark Meyerson: So this proposed model here will have us 80% invested in equities?

John Cripe: Yes, it will be coming pretty close.

Don Taute: I think it's real close to 80% equities.

Max Callen: It becomes a maximum number.

John Cripe: With our real estate and the other holdings, it won't quite get to there, but

it's a maximum.

Max Callan: On with the parameters? The second page we have group allocations. You have domestic equities at 40%, domestic fixed at 20, and international equities at 30%, and real estate and then some other, so you'll be at the 70% total equity number.

Don Herz: Can you sell your real estate investments to implement this?

Paul Lutomski: It would take a little while.

John Cripe: It takes time. That's the only part, and we talked about it the other day, that's the only part that makes me nervous is that our real estate has been extremely soft the last year and a half, and it has produced a good fixed return for us although we have seen CNL reduce their dividend, so we are trying to buy out some of that, and it takes a while to do it. It will take us a couple quarters to buy out the one that they reduced the dividend, and so it takes time to sell it.

Max Callen: Some things you can get out of right away. Other things it's like turning a big ship. It takes a little while.

Paul Lutomski: The JP Morgan we could sell all of it in about three months if we put in a request now. They gather requests at the end of every quarter and then they pay them out at the quarter after that. So three to six months to cash out.

John Cripe: Some of the members will remember but we bought those on quarterly increments, because you can only sell them on a quarter, and we bought them over the course of a year each quarter so that we were constantly able to buy out and so I think today Paul's right. I think you could just say, "Pay them on out."

Paul Lutomski: We've held them long enough.

John Cripe: Yes, we've had them long enough now.

Paul Lutomski: You have to hold them for a year. Same for the RREEF real estate.

John Cripe: We made our last real estate investment in RREEF last summer, so that - or, Paul, was that the fall?

Paul Lutomski: It was in the fall of 2004.

Max Callen: In real estate, that's something that you can work at and see what your dividend pay stream is coming in and if it's above the seven and a half

percent, we don't sell it. I mean our model is using the 7 number, and that's why it crunches it the way it is. If you know you can get 7.5, you don't necessarily have to reduce it.

John Cripe: Yes, and we put in our request to cash out some of the CNL in - was it May or first of June? - because of their reduced dividends, because the dividend was the cash we needed and so we put in a request to, we haven't seen the payment yet, but to be paid the next quarter, quarterly, and so it will take us a little time to move in and out of real estate. It won't be overnight.

Max Callan: And CNL went from about the 7.5 number down to a 5, or a 5.5 number.

John Cripe: Right. When we originally had the proposal, they were talking about 8, in terms of their dividend and now they're down to almost 5, so clearly that's the part that we were buying it for, not as much as the appreciation. It was appreciating also, but we needed the cash flow and that made a pretty standard cash flow system for us for making payments without selling anything else to make our regular payments.

Mark Meyerson: Has the appreciation slowed down, at the same rate as the dividend?

John Cripe: Yes, the appreciation is ... was not a tremendous factor with regard to CNL. It's a good investment, it was going to be pretty stable, it's done pretty well for us, but -.

Paul Lutomski: We don't book any appreciation on CNL, because they don't send us market values. JP Morgan and RREEF send us monthly market values, but CNL doesn't, so we just keep it where we bought it at.

John Cripe: And then we bought some of their alternative investment where their building.

Paul Lutomski: That's also booked at purchase price.

John Cripe: Right. And what's that, that return? What's that?

Paul Lutomski: 10%.

John Cripe: So those are our solid pieces on the real estate side, so.

Max Callan: The publicly traded Reit market, which you noticed flattened out, a lot, isn't increasing like it used to increase. Price-wise.

Gerry Finnegan: This is on a different subject. You're - R-squared at 94. Is that what you are projecting your proposal portfolio is going to correlate to relative to a

combined custom combination of our benchmarks?

Max Callen: Well, what we used there was a Dow Jones moderate portfolio and so this portfolio where you've got bonds, foreign, and all sorts of things into it, I tried to say, "Okay, what would this maybe look like and so that's the index that shows is the Dow Jones moderate, so that's what brings R-squared into place. If we brought a different index in there, it would come up with a different R-squared. In this database, we've got about ... oh, 300 different indices that you can model it after. If I change one of those, it would change that. So in terms of this particular deal, I don't know that I'd pay a whole lot of attention to the R-squared of this model, simply because I don't know whether I've got the right index.

Gerry Finnegan: Okay.

Max Callen: Our large cap manager are we comparing him against the Russell 1000, the R-squared becomes much more important there, than it does in this hodgepodge of indices.

Gerry Finnegan: So that's really the portfolio against the Dow Moderate is what that is. Okay.

Max Callen: Yes. Yes.

Paul Lutomski: Can you make a custom benchmark?

Max Callen: You know I think you can.

John Cripe: I think he did. That's what he gave us.

Max Callen: Well, I mean I just used one of their 300. Okay. And said this is what I think it would look like. If we said, okay, we wanted a model, an index based upon 20% less than 2,000, we could probably do it.

Paul Lutomski: Well, for next meeting.

Max Callen: In that case, your R-square would be 100. I mean it would match what your portfolio was.

John Cripe: In terms of action today, this group is approving the allocation moving forward or not approving.

Max Callen: Right.

John Cripe: Approving or not approving the allocation going forward or structured for this entire next year, because as a group you've kind of set up the manager

review to be January time frame and the asset allocation discussions will be this meeting. So the action is to approve this recommendation or move forward or not approve, whatever.

Max Callen: And then we would take, if it's approved, if it's not approved, and make - the two different approaches. I think there's the approved to a 30% international discussion, but then there's also a based upon the new model even at the 15% international, there's some funds we would sell, there's some funds we would add to, et cetera.

Don Taute: That's what I was going to ask. Because there was that question that we'd had the discussion on before about possibly changing the cap 20 and looking at, as Paul points out in the agenda, the mid-cap growth and that's part of the mix too, as I would see it. Moving forward, right?

Max Callen: Right.

Don Taute: If it took us the time to sell some of the real estate and in our quarterly meeting, which would be in October, you come to us and say "yes, we've sold out A, B, and C," or "we've sold the real estate and got the cash," you are now making a recommendation to move to company A based on your global, and here as to your selection and why, you could go over that pick all over again. Correct?

Max Callen: Right. Right.

John Cripe: I mean because it doesn't happen overnight. I mean we move particularly with either hedge or real estate or some of the bonds, it doesn't - it's not to our advantage to just walk out tomorrow and try to sell it, so between now and next meeting then you decide what manager to select, and make appropriate, and then you'd all vote on it again and say -.

Max Callen: Especially the adding of a new manager. You'd review that. If we're going to take some money away from one of the existing managers because the model says we've got to put it some place else, we can certainly bring those decisions to you, but we hope that you would say "no, you just take it wherever you think you ought to take it from."

John Cripe: On existing managers, but if you added the mid-value, which we were talking about, and you were taking away from the cap 25, then that's an allocation or decision that you don't bring back to the group in October and say, "Yes, we've selected this mid-value manager because of a, b, c, and this is our dollar value."

Gerry Finnegan: We don't have an allocation for foreign fixed income in there, and I thought maybe two, three meetings ago we had discussion about foreign

fixed income and whether or not they should hedge their currency.

Max Callen: There is that category, but because of the return parameter that we put into it, it just didn't allocate any money into it. Did you still want to have the minimum of some number in foreign fixed?

Mark Meyerson: Any other questions?

Don Herz: What is this, the portfolio standard deviation of 10.9, what does that mean again?

Max Callen: The standard deviation is volatility of returns.

Gerry Finnegan: If you use IQ as an example, if we gather up all the fourth graders in the world and stand them out in the field in single file with the IQ of 100 being in the middle and on either side of them the kids with 99 and 101 and so forth, you end up with a bell curve. Standard deviation for IQ is 15 IQ points, and that means between IQ of 85 and 115 points standard is one deviation, you have 68% of all the fourth graders in the country. If you go out two standard deviations, which would have been 30 IQ points, all the kids from 70 to 130, that's 96% of all the fourth graders. So when you're dealing with investment returns, there is a known group. In this case the 10.93, but on the bell curve represents that plus or minus bunching.

Don Herz: And that's a one year number?

Max Callen: Yes.

Don Herz: So a 90% probability of hitting the 8.91?

Max Callen: No.

Gerry Finnegan: What it says is if you've got a one year return of 8.91, there is a 68% chance that that will be between 19.8 and a negative 2. Okay, in one year. Over ten years, you're looking at a 68% chance that it's probably going to be between 7 and 11. Time causes your bell curve to get very narrow and tall.

Mark Westphalan: So if you have a higher standard deviation, say of 25 or 30, and you're looking for an average of 9, I mean you could have one year swings of anywhere between a negative 21% to as high as 39%, so that the narrower the standard deviation, the better chance that you've got of not having those wild swings that just drive you nuts.

John Cripe: And we were looking for consistency. Originally, but the first model was . . .

Don Herz: And your efficient frontier curve on the current portfolio versus the proposed one is much steeper, so I'm assuming with the steeper that is, the ... higher

?????: Higher the standard deviation.

Max Callen: Right. It's trying to put more into foreign, right there is your foreign. So it's trying to put the most it can into the one that produces the highest rate of return. Now again we assumed that it would produce the highest rate of return.

John Cripe: Max, you said that there were two pieces, do you think it's necessary for a motion on both pieces? Or can one be done with just approving your allocation and moving forward?

Max Callen: That's up to you. I mean our suggestion would be that you do go to the 30% foreign allocation parameter.

John Cripe: And that's capsulized in your proposed, right?

Max Callen: Yes.

John Cripe: So if the motion was to approve your proposed, then that takes care of that then.

Mark Meyerson: Why don't we take about 5 or 10 minutes and then come back and have any further discussions or motions that we want to have and decide which way we want to go on this? Thanks, Max and Todd, for the presentation.

(BREAK)

Mark Meyerson: Okay, does anybody have any more questions for Todd or Max before we decide whether we want to adopt the proposed asset allocation portfolio that they have recommended? Any further discussion? *(Silence)* Does anybody have any motions?

Mark Westphalan: One question before we entertain a motion. At this point in time, I'd like to suggest that we eliminate our exposure to the cap 20, cap 25 fund completely and move out of that over a gradual basis to either - to replace that with a mixture of a mid-cap growth or mid-cap growth and value fund, and just eliminate our exposure completely to that. The reason why I'm suggesting that is that I use that model in my office from time to time with aggressive people who are looking for the most undervalued stock idea that I can come up with, with the most certainty that it will go up in value, and it just has seemed that that listing of stocks has not done as well

in the last 12 months as it has in the last 24 to 36 to 48 months and I'm just thinking that where markets are at today, looking for more dividends, higher dividends, more consistency that I just think it would be best on our respects to pull out of that investment completely. I don't know what anybody else thinks, but.

Max Callen: It is a more aggressive strategy. There is no large cap, small cap, mid-cap box that you put it in. I mean they buy all sorts of securities and it's a very narrow focus, with 25 names that get into the portfolio. The bogey is the S&P 500, to try and beat it, and they've historically done that. But again we wouldn't argue to keep it in. It definitely is not a mid-cap.

John Cripe: Your original recommendation was just that, to reduce at least by half, and move to a traditional mid-cap value, I think it was.

Max Callen: No, it's a mid-cap growth. Mid-cap growth is where it was originally plugged into the model, and that's where it was when we first started using the model.

John Cripe: And certainly with the idea that we would have to do that over some period of time.

Mark Westphalan: Right.

Mark Meyerson: So that would just be a revision you'd want to make to the portfolio.

Don Taute: Want to make that in the form of a motion?

Mark Westphalan: I would move that we eliminate our exposure to the Smith Hayes Cap 25 over a measured period of time, not to come out in one day, but to come out over a period of weeks or months.

Max Callen: Just so you know it has quarterly entrance/exit time periods, so it may be over the next six months, the next two quarters, something like that.

Don Herz: I'll second that motion.

Gerry Finnegan: Is the first opportunity we'd have like the first of October quarter?

Max Callen: Ah, yes. Yes.

Mark Meyerson: Any further discussion on that motion? All those in favor say "Aye." (*Chorus of "Aye"s*) Any opposed? Motion passes. Okay do we have any other motions that reference the model we've been shown?

Don Taute: I make a motion that we adopt the proposed asset allocation that's been

presented today.

Greg Sorensen: I'll second it.

John Cripe: And that's, for the record, containing the original or the modifications just made?

Don Taute: That would be with the modification, and with the motion just adopted to gradually move out of the Cap 25 over the next two quarters.

Merk Meyerson: Any further discussion on that? All those in favor say "aye". (*Chorus of "Aye"s*) Those opposed? Motion passes. I think that takes care of the business that we had on the agenda. Does anybody have any new business they want to discuss? Nobody has new business?

Brad Thavenet: Did we leave anything to the draft to the ordinance?

John Cripe: Well, the allocation numbers are set up with the vote we just had.

Brad Thavenet: Okay, so that will go back into our original draft.

Mark Meyerson: Anything else? We need a motion to adjourn.

Several voices: So moved.

Mark Meyerson: Okay. We're done

John Cripe: Hey, before you go, October we've saved again for an educational session and we'll try to work between now and October for another educational session someplace, bringing in either one of the managers or whatever. I mean we think it's extremely important to have that opportunity and we still think it's important for you all to have the opportunity to, if we can't bring them here, to go someplace to get some further understanding of what you're voting on, so we'll continue to push to - for both of those things, internal and external education, so.

Brad Thavenet: When you and Paul get conference invitations and send them out to us, can you put a sticky note -? I mean we get such a barrage, there's some that you would think would be better than others, you know, as you get them, like you know "this one historically has been a bit better than, you know, this one over here" type of thing. Because I mean you send so many of them that it's hard to -.

John Cripe: I know that when I've gone to, represent Police and Fire a couple of years ago, several of the investments and ideas have eventually made it into the portfolio or to the post employment health plan. And so it is geared

toward trustees and managers of police and fire pensions. Other than “Guns and Hoses.” You don’t see it geared toward police and fire, you’re just going to go to all the discussion. NAPO and Guns-’N-Hoses are geared toward defined benefits and particularly your issues, so we’ll try to highlight those two.

Paul Lutomski: I have a topic for new business discussion for the committee. What types or would you like to form a subcommittee to tell me what types of interim information you’d like to receive? Do you want me to send out a newsletter saying, “These are the transactions that occurred, this is the percentage we earned for last month,” and just whatever information on the portfolio that you’d like to get between the meetings on some sort of regular basis?

John Cripe: I mentioned to Paul that we used to do the cash flow analysis with regard to what we estimated our cash needs were every time you had a meeting, and that’s kind of gone to the wayside, but we certainly could -. Paul has it. We could produce it. Either a monthly email or something like that. If you want to have a subcommittee get together and review that, you don’t have to do it this month, but you could do it next time you meet. You could get overwhelmed with paper, so you might want to just look at pieces of it, of interest that we could produce so that you all could see it. Okay?

Paul D. Lutomski: Or just contact me individually and I’ll add everything up, and we’ll get it out there, and change it, add to it, subtract to it, as people feel it’s necessary.

John Cripe: Then we could talk about it in October. Take a few minutes and talk about it and see what you would like and hand you some samples.

Paul D. Lutomski: I also get invitations from the managers to participate or listen in on a conference call, so I could forward those emails to anybody that’s interested.

John Cripe: You could get pretty overwhelmed with the stuff that we get, so.

Paul Lutomski: I can contact most members through work email, but for Police the email linkage is bad, you’ve got the CICS system, I believe, and we’re on Lotus Notes, so I can’t really send attachments or anything like that. I don’t know if you’re interested in, if you have a home email, or if you want me to just interoffice the materials?

Mark Meyerson: We’ve got PC’s. We should be able to open attachments, if we open them on a PC.

Randall Case: What did you want to do about that discussion about increasing the amount we contribute?

Don Taute: I think we'll just probably meet, yes, sometime when all the budget's done, and once we get into the new fiscal year.

Randall Case: That would be great. I'd like to bring that forward, in our new business sometime. I'd like to see what's happened. Look at that report.

Mark Meyerson: Any other new business?

Don Herz: Paul, I should know this. Do we -? Do you issue a separate audit report, or is it just part of the City's, the City-wide audit?

Paul Lutomski: It's part of the City's. They don't audit the return that we post to the members' accounts. They audit the data that we send to the actuary. They audit the balance sheet that we send to the actuary. But we've looked into hiring, I think it was KPMG, to audit our returns, but they wanted so much money it was ridiculous, then we didn't do it. Maybe we should work with you on that, to get a return audit.

Don Taute: What kind of number did they quote you, to do it?

Paul Lutomski: Do you remember? (to John) I think it was like \$20,000.

John Cripe: Yes. It was more than our actuary charges.

Don Herz: We do have a new City Auditor. Maybe we should sit down and ask, talk to them.

Randall Case: Paul, I've got a question for you. Are a -. Isn't our first batch of people just leaving the DROP, is it this year? Or is it next year?

Don Taute: Next year.

Paul Lutomski: Actually the DROP is kind of nice for cash flow. We start paying the monthly payments into their DROP account, or if they have a lump sum option and choose to roll it, we roll the money then. So there won't be a huge cash outflow when those people leave. It won't really affect the pension plan at all, because the money that they have accumulated in their DROP account is already in there. But it will be big for the Police and Fire Departments.

John Cripe: The Department gets the hit, because of the, you know, the sick leave payout, and the vacation. That's where the hit comes, but the plan won't feel it that way. Well, we're always having problems. I mean we're

always monitoring cash, we're always spending it.

John Cripe: Yes, the people who walk out and don't DROP will take their 100,000 or 250,000 and rollover and we transfer it. Those have been decreasing because of the DROP and so our cash in that regard isn't as big as it used to be. We were sitting with a million or so a month because of unexpected terminations.

Brad Thavenet: Did you guys ever discuss the reverse DROP? Guys that would get in at say 45 and DROP five years at 50 that just want to leave earlier than what they do now?

John Cripe: We've talked about that. That The funding mechanisms don't ... aren't applied the same way that we apply ours, and so actuarially it actually would deficit to us instead of sort of a neutral.

Paul D. Lutomski: That would be a huge cash flow issue there.

John Cripe: Yes, we'd have some major problems with that. The same is true of people who could DROP and then sign up and return. I've seen those plans as well, and they really do cause a lot of mystery problems. So this is about as straightforward as we can get.

Randall Case: Are there any news on the DROP period? I know we've established five years, but is that set in stone? Could that period be greater?

John Cripe: Yes, it's set in stone.

Paul Lutomski: It's set in Lincoln Municipal Code.

John Cripe: And typically in the market you see some limits attached to everything, and five is usually the outside of that limit. You do see some 3's, 4's and 5's. So.

Randall Case: I've even seen some 7's.

John Cripe: When we were going through it, we had quite a bit of discussion with regard to where we set it.

Mark Meyerson: Anybody else?

Gerry Finnegan: Quick question on the (????????) of Police and Firefighters is we kind of got into a bit of a probability of statistics here today and it just reminded me how probabilistic what we deal with is and those of us that deal with it all the time, it gets second nature. Would it be helpful during one of our educational sessions to maybe devote an hour to going over that stuff, or

do you feel like maybe you're comfortable enough that?

Randall Case: It's years, since you took statistics.

Brad Thavenet: My undergrad is in actuarial, and it's probably been 15 years since I opened one of those books. I mean it's rusty, sitting here looking, digging through the minefield to try to figure out the standard deviation. Oh, yes, that's what, but yes, I think it would be very valuable just to. So for one of our educational sessions at some point maybe we could, just have terminology 101. You know the type of thing.

John Cripe: Our first one 2 years ago, we did a little bit of that terminology. You guys did that, standard deviation and ..., but it doesn't hurt to keep it up. And then you get more complicated from where we were.

Mark Meyerson: Well, I think we're done. I think that's it. Thank you.